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Utilizing the Income Approach to Appraise Outpatient Enterprises

Healthcare related outpatient enterprises are those that provide services that do not require hospital admission and may be performed outside the premises of a hospital. Valuation of healthcare related outpatient enterprises, similar to valuation of any business, should include consideration of the three general approaches to valuation, i.e., the *income approach*, the *market approach* and the *asset/cost approach*. Use of specific methods under each approach will be guided by the facts and circumstances of the engagement, e.g., availability of data, nature of the current transactional marketplace, etc. This article focuses on utilizing an income approach to value outpatient enterprises, while subsequent articles in this topic series will address the use of a market approach and an asset/cost approach to value outpatient enterprises.

Development of an opinion of value related to a healthcare related outpatient enterprise using an income approach typically involves: (a) forecasting the *net economic benefit* to be derived from ownership of the subject property interest; (b) determining an appropriate *risk adjusted required rate of return* for an investment in the subject property interest; and, (c) discounting the forecasted net economic benefit stream by the risk adjusted required rate of return, to arrive at the *present value* of the future net economic benefit stream. Two widely utilized income approach based methods for valuing healthcare related outpatient enterprises are the *Discounted Net Cash Flow Method* (and only under certain circumstances) the *Single-Period Capitalization Method*.

Determining the level of net economic benefit to be derived from ownership of healthcare related outpatient enterprises includes an analysis of the *value drivers* and *risk adjustments* specific to these types of businesses, which include, but are not necessarily limited to: [1]

(1) *Scope of Services* – the range of different services/procedures offered by an outpatient enterprise can directly contribute to the subsequent net economic benefit stream (e.g., a multi-specialty physician practice may be able to add service lines with minimal *marginal cost*, as they already have the necessary equipment in-place and personnel being utilized in similar functions).

(2) *Capacity* for future growth – the level of existing capacity may have an impact on the ability for the subject enterprise to increase productivity without incurring additional economic expense burdens (both operating and capital), as additional cost burdens typically lead to lower value, all else being equal. Economic operating expense burdens would include the necessary staff and supplies needed to support additional volume. Economic capital expense burdens would include additional space and equipment needed to support growth;

(3) *Payor Mix* – outpatient enterprises that have a more favorable mix of payors (i.e., those that reimburse providers at rates higher than those of other payors) would be able to command higher reimbursement yields, leading to greater value, all else being equal;

(4) Efficiency of *operating expense structure* - The magnitude of operating expenses is dependent largely on the type of outpatient enterprise. While higher costs typically indicate lower value, it should be noted that enterprises that utilize more *sophisticated technologies* may be able to increase market share, and therefore, from a financial economic perspective, the costs of these technologies must be weighed against any future benefits when assessing the value proposition of new technology, and the impact it may have on the value of an enterprise.

(5) *Capital structure* – In cases where the outpatient enterprise is valued on a *control basis*, a typical adjustment to the *capital structure* would be based on the reasonable assumption that, in the long-term, the *debt-to-equity ratio* of the enterprise would approximate *industry-indicated benchmarks*.

(6) *Stability of the Supply Chain* – The valuation analyst must consider the reliability of the supply portion of the value chain, and its relation to the subject enterprise's *projected income*. In general enterprises achieve a significant amount of their *bargaining power* from their relative *size* within their *market service area*, and tend to enjoy *negotiating power* for a lower per-unit fixed cost (i.e., economies of scale).

(7) *Market Rivalries and Competitors* – the competitive marketplace is a key factor in assessing the level of risk inherent in an investment in the subject property interest.

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Other factors to consider when performing the valuation of a healthcare related outpatient enterprise include underlying assumptions (e.g., hypothetical conditions or extraordinary assumptions) that may be necessary due to the nature of the transactional marketplace for the subject property interest. For example, when valuing an the ancillary service and technical component (ASTC) service line of a physician practice, under the hypothetical condition[2] that the ASTC service line is a *stand-alone* business, in contrast to the service line's current operation as part of the practice (e.g., the diagnostic imaging component of a cardiology physician practice), certain elements should be considered to develop an efficacious opinion of value:[3]

(1) The market service area contains *sufficient demand* for the technical services of the ASTC service line to support the projected, post transaction volume of procedures of the ASTC service line, as an independent operating enterprise. This relates to the *Commercial Reasonableness* of the transaction, i.e., there must be a need for the services offered by the ASTC enterprise, in the market service area of the subject ASTC enterprise, in order for the transaction to be deemed *Commercially Reasonable*;

(2) There is a sufficient supply of physician manpower within the geographic proximity limitations of the market service area, separate and aside from those that currently own, or those who are currently employed, by the subject practice, to support the technical services of the ASTC service line, post transaction, as an independent operating entity, in a manner that clearly establishes that there is no remuneration based on the volume or value of referrals from the subject practice physicians:

(3) The revenue stream from which the economic benefit is derived should be *quantifiable* and *separately identifiable* from the revenue stream of the professional component of the physician practice;

(4) An *appropriate economic operating expense burden*, accurately allocated between the defined services and revenue of the ASTC service line to be appraised and the residual practice revenue streams, as well as an *appropriate economic capital expense burden*, should be developed to be applied against the revenue stream of the ASTC service line to arrive at the economic benefit of ownership to be capitalized into value;

(5) An appropriate *risk adjusted required rate of return* for the ASTC service line should be developed that reflects the *hypothetical nature* of the ASTC service line and the uncertainty related to the projected operations of the ASTC service line, which has been converted from a *well-established business* with a presumably steady referral stream to a more *risky venture* with less certain referral patterns. This adjustment is typically reflected in the *company specific risk premium* component of the cost of equity, which is *increased* to reflect the uncertainty of the projected cash flows in comparison to those reflected in the historical financials or productivity reports, so that the risk adjusted required return on an equity interest in the subject "carve out" ASTC enterprise (including all other forms of company specific risk) approximates seed-stage, venture capital (VC) required rates of return (which ex-post VC rates recently have been in the range of 22.5% - 45.0%[4]); and,

(6) The anticipated hypothetical transaction is conducted in compliance with the *Anti-Kickback Statute*, which makes it illegal to knowingly pay or receive any remuneration in return for referrals, as well as, other legal and regulatory edicts in the healthcare industry.[5]

The initial calculation derived from application of the *income approach* may need to be adjusted to reflect the basis and/or level of control of the subject property interest. Adjustments that are often considered when valuing healthcare related outpatient enterprises include:

(1) *Discount for Lack of Control* - an amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control.[6]

(2) *Discount for Lack of Marketability* – which is meant to reflect two circumstances that impact the monetization of property: (1) liquidity (or lack thereof) which typically refers to the ability of the seller to convert their investment into cash, with certainty as to the amount and timing of the proceeds; and, (2) and level of marketability of a business interest which refers to the relative transactional costs of monetizing an interest in a closely held enterprise, in contrast to the transactional cost of a property interest where there exists a previously established market for the specific business interest being sold (e.g., publicly traded shares that are bought and sold on a stock exchange enjoy a high level of marketability in contrast to shares in the same company that may have certain restraints as to being traded on the exchange). [7]

(3) *Key Person Discount* – an amount that reflects the perceived probability of the risk that some exigency or adverse circumstance could befall the continued participation of a key individual of the subject business and in turn affect the level of economic benefit generated by the enterprise. [8]

A discussion on each premium and discount was deemed to be outside of the scope of this article. However, numerous sources are available on premiums and discounts for further reference. [9]

The next two installments of this five-part series will address the use of a market approach and an asset/cost approach to value outpatient enterprises, respectively.

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1 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services," By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, Vol. II, p. 444-472.
2 See September 2014 HCC Topics article titled "Appropriate Use of Extraordinary Assumptions and Hypothetical Conditions" for further definition of hypothetical conditions.
3 Cimasi, 2014, p. 572-573.
4 "2014 Capital Markets Report," By Dr. Craig R. Everett, Pepperdine Private Capital Markets Project, 2014, p. 8.
5 "Criminal Penalties for Acts Involving Federal Health Care Programs," 42 U.S.C. § 1320a-7b(b).
6 "International Glossary of Business Valuation Terms – NACVA." http://www.nacva.com/association/A_bv_terms.asp, (Accessed 10/14/2014).
7 Cimasi, 2014, p. 137-151.
8 Ibid, p. 157-159.
9 For example, see "Business Valuation Discounts and Premiums: Second Edition" S.P. Pratt, John Wiley & Sons, Inc., (2009); "Discount for Lack of Liquidity: Understanding and Interpreting Option Models" by Ashok Abbott, PhD. Business Valuation Review, Vol. 28, No. 3, Fall 2009; "Valuing a Business The Analysis and Appraisal of Closely-Held Companies" by Shannon Pratt, 5th edition, McGraw-Hill Companies, Inc., New York, NY, 2008; "Quantifying Marketability Discounts" by Chris Mercer, Peabody Publishing, Memphis, TN, (1997); "Do Privately-Held Controlling Interests Sell for Less?", by John R. Phillips and Neill W. Freeman, Business Valuation Review, September 1995 (Vol. 14, No. 3).

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